MiFID ESG Fact Sheet

BNP Paribas
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MiFID ESG Amendments

In April 2021, the European Commission issued new rules amending MiFID II to incorporate ESG factors. The changes are expected to apply from August 2022 and impact all EEA MiFID II investment service providers and their EEA branches. This factsheet gives an overview of the MiFID 2 ESG Amendments and timeline for their implementation.

1. BACKGROUND

In tandem with the publication of SFDR[1,] and Taxonomy Regulation ("TR")[2] in 2019-2020, the European Commission published its changes to MiFID II in Delegated Acts[3] to incorporate new ESG requirements ("**MiFID ESG Amendments**")[4]:

1. **New MiFID sustainability preferences** regime applying to EU portfolio managers and investment advisers ("**Distributors**") to consider the "**Sustainability Preferences"** of clients as part of the suitability assessment **("MiFID SP amendments")**.
2. **Product Governance** requirement applying to MiFID 2 firms that manufacture and distribute MiFID instruments to factor "**Sustainability related objectives**" in their Product Governance ("**MiFID PG amendments**").
3. **Organisational requirements** applying to all MiFID 2 firms to incorporate "**Sustainability Risks"** into their risk management, conflicts and other organisational frameworks ("**MiFID ESG Organisational Requirements**")

These MiFID ESG amendments have not amended the scope of applicability of the existing MiFID related requirements.

MiFID 2 ESG CHANGES

Timelines:

10 Mar '21: application of SDFR L1

21 Ap '21: publication of MiFID2 Delegated Acts ("DA")

2 Aug'22 MiFID DA Suitability Preferences applies.

22 Nov'22 MiFID DA Product Governance applies

1 Jan '23: application of SFDR L2 incl Art5&6 TR product disclosures for all environmental objectives

2. TIMING

The MiFID SP amendments will enter into force on 2 August 2022. The MiFID PG amendments will enter into force on 22 November 2022. BNP Paribas has engaged with the industry to request a deferral of both implementation dates to 1 July 2023 or later[5].

Indeed MiFID SP amendments rely on the availability of sustainability information to be available under the additional product governance rules as of 22 November 2022 and information to be reported under the SFDR, Taxonomy Regulation ("TR"), and NFRD/CSRD available not before January 2023.

3. KEY CONCEPTS UNDER MiFID ESG AMENDMENTS

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[1] **Refer to our GM SFRD factsheet:** SFDR published on 9 Dec 2019 (Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector) already imposed some ESG disclosure obligations on asset managers and portfolio advisers since March 2021 and was complemented by the Taxonomy Regulation published in June 2020 (Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088)

[2] Refer to our GM SFDR factsheet

[3] **Commission Delegated Regulation 2021/1253** of 21 April 2021 as regards the integration of **sustainability factors, risks and preferences** into certain organisational requirements and operating conditions for investment firms, amending Delegated Regulation (EU) 2017/565.

Commission Delegated Directive 2021/1269 of 21 April 2021 as regards the integration of sustainability factors into the **product governance** obligations amending Delegated Directive (EU) 2017/593

[4] 3 other financial service sectoral Delegated Acts (UCITs, AIFMs and Solvency II and IDD) integrate similar sustainability requirements for these sectors, respectively Commission Delegated Directive 2021/1270, Commission Delegated Regulation 2021/1255, Commission Delegated Regulation 2021/1256.

[5] Joint trade association AFME/ISDA/EBF Letter 28 Jan'22 to the EC.

MiFID ESG Amendments introduce new concepts to MiFID II and import concepts from SFDR and TR.

New concept:

- **Sustainability Preferences ("SP"):** this is a new concept and essentially comprises 3 specific types of sustainability preferences (see detail further below)**.**a particular client (retail or institutional) may specify going forward preferences to Environmentally Sustainable Investment, Sustainable Investment, and Principal adverse impacts on Sustainability Factors.

Concepts imported from SFDR or TR:

- **Sustainability Risk:** an environmental, social or governance event or condition which, if it occurs, could cause a material negative impact on the value of an investment.
- **Sustainable Investment**: an investment in an economic activity which (1) contributes either to an environmental objective or a social objective (2) does not significantly harm ("DNSH") any environmental or social objectives and (3) the investee company follows good governance practices.
- **Principal adverse impacts on sustainability factors (PASI)**: potential negative effects of investment decision on ESG matters.
- **Sustainability Factors:** an environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.
- **Environmentally Sustainable Investment:** an investment in one or several economic activities that qualify as environmentally sustainable (under TR).

4. MiFID SP AMENDMENTS (for Distributors)

• In-scope Firms/ "Distributors"

MiFID SP applies to EEA firms providing:

- Investment advice
- Portfolio management.

Including their EEA branches.

• In-scope Products

MiFID SP applies to all MiFID 2 financial instruments.

MiFID SP scope is broader than SFDR Products which applies to funds and funds-like products.

• Background & new requirement

The assessment of suitability[6] is one of the most important obligations for investor protection. Suitability aims to ensure that the products recommended meets the client's interests. Suitability has to be assessed against clients' knowledge and experience, financial situation and investment objectives. To achieve this, In-scope Firms have to obtain the necessary information from clients[7] and provide them with reports (only for retail clients).

Under the new regime, going forward, it will be mandatory for In-scope Firms to:

- capture information about a **client's sustainability preferences**; and
- <u>where a client has such preferences</u>, to take them into account when recommending products.

• "MiFID 2 ESG Eligible Products"

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[6] Article 25(2) of MiFID II and Articles 54 and 55 of the MiFID II Delegated Regulation: investment firms providing investment advice or portfolio management have to provide suitable personal recommendations to their clients or have to make suitable investment decisions on behalf of their clients

[7] From a practical perspective thus means that the client's questionnaire will have to be amended with additional questions.

Step 1: In-scope Firms must obtain the information from their end-clients as to whether they want all or some of their products to fall within one or more of the following "Sustainability Preferences" categories:

"Sustainability preferences" means a client's choice as to whether and, if so, **to what extent**, either of the following should be integrated into their investment strategy:

1. Category 1: a financial instrument for which the client or potential client determines that a minimum proportion shall be invested in **Environmentally Sustainable Investments** (as defined in TR);

2. Category 2: a financial instrument for which the client or potential client determines that a minimum proportion shall be invested in **Sustainable Investments** (as defined in SFDR);

3. Category 3: a financial instrument that considers **principal adverse impacts on sustainability factors** where qualitative or quantitative elements demonstrating that consideration are determined by the client or potential client.

Step 2: if yes, then the end-clients have to specify how much:

- For category 1 and 2, minimum proportion they want
- For category 3: what quantitative or qualitative elements will be required to demonstrate the consideration of PAI

• SFDR /non-SFDR Products

For products that fall into the scope of SFDR, the information disclosed under SFDR will be used to identify the MiFID 2 ESG eligible products:

SFDR information	MiFID ESG Product
Percentage of alignment with TR	Category 1
Percentage of Sustainable Investment	Category 2
PASI consideration	Category 3

MiFID 2 financial instruments (i.e. stocks, bonds, structured products …) not covered by SFDR may use the concepts defined in SFDR to determine whether or not these financial instruments are eligible to the MiFID categories.

5. MiFID PG[8] AMENDMENTS (for Distributors and Manufacturers)

• In-scope Firms/ Distributors

MiFID PG applies to all EEA Distributors and manufacturers and their EEA branches.

• Background & new requirement

MiFID 2 requires EEA manufacturers and distributors to set up an approval procedure for new investment products. The latter must be such as to ensure that the investment product will be distributed to the identified target market and identifies the inherent risks to it. This step is the definition of the target market of the product[9].

The MiFID amendment adds a new requirement **on Manufacturers**: they must consider **Sustainability Factors** in the product governance, approval and oversight. This includes:

- **Considering sustainability-related objectives of their financial products** in analysing potential target markets, and consistency of the financial instrument objectives with the target market. This consistency should be reviewed on a regular basis.
- **Presenting transparently sustainability factors** so that distributors can consider the sustainability related objectives of their clients.
- **Maintaining product governance arrangements** between manufacturers and distributors to ensure that **products and services are compatible with clients' needs must include their sustainability related objectives** and this should be reviewed on a regular basis.

6. MIFID ESG ORGANISATIONAL REQUIREMENTS (for all EEA MiFID 2 investment firms)

[8] Refer to GM MiFID Factsheet Product Governance

[9] Identify a target market=determine with a general view of how the specifics of the product would be compatible for certain types of investors, and verify that the investment product meets the needs, characteristics and objectives of the identified target market

- ## In-scope Firms/ Distributors

This applies to all EEA MiFID investment and service providers and their EEA branches.

- ## New requirement

In-scope firms will have to incorporate sustainability factors in their framework as follows:

- **Organisational requirements**[10]: in-scope firms must take into account sustainability risks when complying with the general organisational requirements imposed by MiFID II.
- **Risk management**: in-scope firms must take into account sustainability risks into account in their risk management policies and procedures.
- **Conflicts**: in-scope firms must regard damage to a client's sustainability preferences as a type of client detriment for the purposes of their conflicts policies and procedures.

7. UK MiFID POSITION

- The UK has not onshored the ESG MiFID amendments.
- Currently there is no indication that the UK version of MiFID II and the other relevant directives will be amended to reflect the new ESG requirements discussed in this factsheet, although the FCA has indicated that it may propose similar sustainability-related rules in due course.
- Given, since Brexit happened on 30 Dec 2020, UK investment firms cannot provide MiFID 2 investment serviced to EU clients, the ESG PG and SP MiFID 2 amendments should not apply to UK investment firm or UK branches of EU investment firms.

8. INTERPLAY WITH SFDR

- **Scope:** the ESG changes to MiFID II have a broader scope than SFDR, e.g.: all MiFID II firms (for some of the new rules) in relation to all MiFID products and services vs SFDR that only covers portolio managers and investment advisers, fund managers, insurance advisers and insurers for certain products only (funds and funds-like products).
- **Product eligibility:** the ESG MiFID changes rely on SFDR and TR definitions in its classification of Sustainability Preferences.
  The SFDR Products classification can be used to identify the MiFID 2 eligible products to "Client's sustainability preferences".
- **Data:** MIFID relies on data disclosure under SFRD and TR.

9. FOR FURTHER INFORMATION

If you have any further questions, please contact GM SUSTAINABILITY <gm.sustainability@bnpparibas.com> or via your usual relationship or sales contact.

[10] Amendment to Art 21 MiFID Delegated Regulation 2017/565